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THE MALAYSIAN FINANCIAL CRISIS: ECONOMIC IMPACT AND RECOVERY PROSPECTS

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I. INTRODUCTION

Prior to the crisis, Malaysia had been dubbed as one of the miracle economies in East Asia owing to its maintenance of high growth rates averaging 8.9 per cent during the period 1988–96 in addition to low inflation rate of about 3–4 per cent per year. Moreover, the increasing emphasis on manufacturing, and electronics in particular, ensured high employment rates for the country.

From July 1997 however, Malaysia began attracting more international attention not for its extraordinary economic performance, but for its entanglement in a major regional economic crisis. At the outset, for the more pessimistic observers it was already doubtful whether Malaysia's target to become a developed country by the year 2020 would still be achievable. After all, for the first time in years, the external value of Malaysia's currency, the ringgit, shrank by nearly 50 per cent while the stock market contracted by even more at about 60 per cent. The ringgit fell from an average of 2.42 to the U.S. dollar in April 1997 to an all-time low of 4.88 to the U.S. dollar in January 1998. The composite index (CI) of the Kuala Lumpur Stock Exchange (KLSE) which had been the third largest stock exchange in the region after Tokyo and Hong Kong, fell precipitously from 1,077.3 points in June 1997 to 262.7 points on September 1, 1997. Between July 1997 and mid-January 1998, approximately U.S.$225 billion of share values were wiped off. Before long, the impact of the financial crisis was being felt in the real sector as evidenced by business closures, retrenchments leading to high unemployment, and increasing inflation levels. For the first time since 1985, the Malaysian economy experienced a recession, contracting by 6.7 per cent in 1998. By nearly all accounts, the current downturn is worse than that experienced by the country in 1985.

The recession experienced in 1985 lasted for only one year with a mild 10 per cent contraction. Two years after the onset of the current crisis, the main problem is whether a similar recovery is will occur for Malaysia this time, or whether the crisis will last beyond 1999. Obviously, some positive signs suggest that the worst is over for the Malaysian economy, although this does not necessarily guarantee that Malaysia is out of danger yet. In the past two years the Malaysian government has resorted to different tactics to withstand the negative effects of the crisis. While some of the strategies employed have been successful, some others have failed.

The aim of this paper, as the title suggests, is to examine the various impacts of the Asian economic crisis on the Malaysian economy, to analyze Malaysia's recovery prospects in the future, as well as to highlight some of the key challenges facing Malaysia on the road to sustained recovery. The paper begins by describing the genesis of the financial crisis in Malaysia and then proceeds to outline the various policy responses of the Malaysian government. In the subsequent section, a snapshot of the crisis' impact on the economy is provided. Malaysia's prospects for recovery and the challenges associated with ensuring sustainable future growth are dealt with in the final section.

II. THE FINANCIAL CRISIS IN MALAYSIA

In mid-May 1997, the Thai baht came under severe pressure from speculative attacks. The ringgit was also not spared, and came under severe selling pressure. Bank Negara Malaysia's (the central bank of Malaysia) immediate response was to intervene in the foreign exchange market to uphold the value of the ringgit. Bank Negara valiantly upheld the value of the ringgit for about a week before it finally was forced to float the ringgit on July 14. By that time, the bank had already lost close to U.S.$1.5 billion in the effort to prop up the ringgit. At its lowest point, the ringgit depreciated against the dollar by almost 50 per cent, hitting a high of RM 4.88 to the U.S. dollar on January 7, 1998. After a brief period of stability during February and March, the exchange rate continued to deteriorate with wide fluctuations in the following months.[1]

Even more drastic than the plunge in the exchange rate, was the collapse of the stock market. Between July and December 1997, the composite index of the Kuala Lumpur Stock Exchange (KLSE CI) fell by 44.9 per cent. Following a slight recovery in the first quarter of 1999, the index again fell, this time to an eleven-year low of 262.70 points on September 1, 1998. On the whole, between July 1, 1997 and September 1, 1998, market capitalization in the KLSE fell by about 76 per cent to RM 181.5 billion. In fact, although it enjoyed the best precrisis economic fundamentals among countries that were hit by the crisis, Malaysia experienced the biggest stock market plunge in the region.[2]

The property bubble also subsequently burst, and the crash was accompanied by

[1] The exchange rate value of the ringgit continued to fluctuate in the following months until it was fixed at the rate of RM 3.80 to the U.S. dollar in September 1998.

[2] There was no improvement in stock prices until the newly introduced selective capital controls brought about some relief in October 1998.

massive capital outflows as confidence in the Malaysian economy became increasingly shaky. As a result, the banking system began to experience increasing non-performing loans (NPLs) which, according to Bank Negara data, rose from about a modest 2.18 per cent in June 1997 to 4.08 per cent in December 1997, and then to a high of 11.45 per cent in July 1998 (Malaysia, EPU 1999). Private sector estimates for NPL ratios at the time were much higher than the official figures suggested, as many companies had begun to roll over debt as part of their survival strategy. Meanwhile, the increase in NPLs in the banking and financial sector was reflected in a sharp downturn in borrowing and financing, bringing about tight liquidity conditions.

After a short time lag, the real sector of the economy also began to feel the negative effects of the crisis. Weak stock prices, the property market slump, and the net contractionary impact of the ringgit depreciation together led to a negative wealth effect which resulted in a general contraction in domestic demand. Consequently, domestic-oriented industries, such as the construction and services sectors, were severely hit. Meanwhile, private investment generally contracted due to the uncertainties arising from volatile exchange rates, the decline in local and external demand, as well as excess capacity and tight liquidity position in the economy. Foreign direct investment (FDI) levels, as measured by the value of applications received in the manufacturing sector and applications for investment incentives from the hotel, tourism, and agriculture sectors by the Malaysian Industrial Authority (MIDA), displayed a declining trend over the period January–December 1998.

In the public sector, a decrease in both expenditure and investment was initially expected following the government's announcement that it was slashing the budget for operating expenses by 18 per cent, not to mention the cancellation and/or postponement of several infrastructure mega-projects. With the slowdown in consumption, investment, and government expenditure, the only source of growth was expected to originate from the country's net exports. The initial impact of the crisis led to declining imports of luxury goods as domestic demand slowed due to the depreciation of the ringgit. Imports in general though, did record an increase (52.7 per cent year-on-year in February 1998). The high import content of Malaysian manufactured exports, especially of capital and intermediate goods, goes a long way in explaining the subsequent rise in imports at the time. Meanwhile, exports rose as well, especially in the resource-based sector, and displayed a continued uptrend in ringgit terms. However, when converted into U.S. dollar terms, most of the major export categories displayed a downward trend.

These developments led to an expectation of lower economic growth in 1998 and 1999. In October 1997, the government forecasted a growth rate of 7 per cent for 1998, but subsequently adjusted it downward to 4–5 per cent in December 1997, and again to 2–3 per cent in March 1998. However, when the national accounts were revealed, GDP growth reached –2.6 per cent and –6.8 per cent for the first two quarters of 1998, respectively. It became certain that the economy would contract in 1998.[3]

The crisis-induced slowdown in economic growth has had an inevitable impact on Malaysia's social sphere as well. The contraction in GDP resulted in the retardation of employment growth, and the rise of unemployment and retrenchment levels. While employment growth had been growing steadily at 4.9 and 4.6 per cent in 1996 and 1997, respectively, it contracted by 3 per cent in 1998. For the whole of 1998, the number of workers retrenched was 83,865, a sharp increase from the 19,000 retrenched in 1997. Inflation levels rose as well, reaching a high of 6.2 per cent in June 1998 before moderating. The inflation rate was 5.3 per cent in 1998.

The rise in unemployment and inflation are the main channels through which the social impact of the crisis has been transmitted because it is through these channels that real household income declined. The unemployment and income effect was mitigated by the buffer effect of an estimated 2 million migrant workers[4] as well as by sustained levels of government spending in the social sector. Nevertheless, a perceptible, and in some cases drastic, erosion of household income and welfare has been unavoidable. In addition to the existing poor, a new group of poor has emerged for whom there are no social safety nets available to cushion the effects of sudden loss of income. Urban families are experiencing the worst of the impact due to increased cost of living, including the cost of food, household necessities, health care, tertiary education, and transportation.

III. THE BUMPY ROAD TO RECOVERY

Recovery efforts in Malaysia have essentially been home-grown, unlike in Thailand, Indonesia, and the Republic of Korea where recovery efforts have, to a large extent, been shaped by the International Monetary Fund (IMF). Conceptually, policy responses by the government after the floating of the ringgit went through two distinct phases, the first being centered around tight fiscal and monetary policies, and the second based on expansionary policies. The formulation of coherent policy responses however, came after a period of uncertainty about what the crisis actually represented, and more importantly the kind of responses that should follow.

It has been argued that in the initial stages of the crisis, the Malaysian government was in a state of shock and denial. Some policymakers denied that there was even a crisis, while some went so far as to acknowledge the existence of a problem, but even then downplayed the seriousness of it (Athukorala 1998). At that time, the lack of a coherent stand by the government led to a severe backlash in terms of

[3] The latest release by Bank Negara (April 1999) showed that the economy shrank by –6.7 per cent in 1998. In the same report, Bank Negara forecasted a modest growth of 1–2 per cent in 1999.

[4] There were 1.14 million registered migrant workers and another half to one million undocumented workers as of 1997.

acceleration of the erosion of confidence in the Malaysian economy. The seriousness of the problem became more manifest with the continuing sell-off of stocks in the KLSE on a massive scale. Only then was there a growing realization among policymakers that the threat of the crisis was real and that unless a clear stand was taken and coherent policies implemented, the crisis would only gradually deepen. The hesitation that the government displayed at the outset was soon countered by a response package announced by the Finance Minister[5] on December 5, 1997, approximately five months after the crisis first hit the Malaysian economy. The package consisted primarily of tightening adjustments to fiscal and monetary policy.

Ironically, although Malaysia flatly rejected the IMF aid package, this first policy approach was, in fact, IMF-inspired. In terms of fiscal policy, the adjustments called for an 18 per cent reduction in government expenditure (including a 10 per cent pay cut for government ministers), as well as the postponement of several infrastructure mega-projects such as the Bakun dam, the Express Rail Link, and the land bridge to Thailand. As a strategy to maintain competitiveness, policies to strengthen the country's balance-of-payments account were pursued. For example, exports were encouraged and imports were discouraged, the latter through an increase in import taxes on certain goods and services. Measures to increase exports included reducing the cost of doing business through such means as tax incentives to boost the manufacturing, agriculture, and services sectors. In order to stem the outflow of domestic funds at that time, the government also imposed a freeze on new overseas investments by Malaysian firms which in 1996 had amounted to RM 10.5 billion (including retained earnings overseas).

In terms of monetary policy, interest rates were adjusted upward to contain inflationary expectations that were likely to follow increasing demand pressures. The statutory reserve ratio (SRR) requirement was kept at the 10 per cent level, though the daily band for averaging balances to meet the SRR was widened. Credit growth was also moderated to approximately 12–15 per cent. Low priority was given to the financing of property (except residential property costing less than RM 150,000 per unit) and for stocks and shares.

While the above austerity package did represent a concrete plan of action by the government, confidence in the economy nevertheless remained shaky as evidenced by the volatile exchange rate and stock market. The primary drawback of this policy phase was that it lacked a long-term focus, in that it merely tinkered with existing policies, but did not address long-term concerns. As a response to this, the government established the National Economic Action Council (NEAC) in January 1998 as a consultative body to the cabinet. The main task of the NEAC was to formulate a comprehensive framework for responding to the crisis. After the National Eco-

[5] The Finance Minister at this time was Dato' Seri Anwar Ibrahim who was both Deputy Prime Minister and Finance Minister until his dismissal on September 1, 1998.

nomic Recovery Plan (NERP) was released eight months later, Malaysian policies to respond to the crisis began to take on a more comprehensive and coherent shape.[6]

One of the key recommendations included in the NERP was the easing of fiscal and monetary policies, as well as the lowering of the cost of capital to revitalize the economy. With this, the focus of economic policies shifted away from the prevention of further economic contraction toward reflation of the economy. With respect to monetary policy, Bank Negara Malaysia reduced the intervention rate from 11.0 per cent to 7.0 per cent, while the SRR requirement was likewise reduced in stages from a high of 13.5 per cent in February 1998 to 4.0 per cent in September 1998 to give borrowers access to funds at reasonable rates. In terms of fiscal policy, the government introduced a stimulus package worth RM 7 billion, as well as earmarked and/or expanded existing specialized funds to ensure priority sectors access to credit at reasonable cost.

Financing the reflation process proved to be difficult when the option for foreign funding received a major blow in the form of a downgrade in the country's foreign currency sovereign rating by two international rating agencies just days before the Malaysian government bonds were to go on sale. Raising funds in the international market suddenly became much more expensive for Malaysia and eventually the government was forced to abandon its plan. The closure of the option to raise funds abroad meant that Malaysia had no other choice but to finance the bulk of the required funds from domestic sources. There was a concern though that this would put an upward pressure on domestic interest rates. Additionally, policymakers were also concerned that lowering interest rates to boost the economy would cause the real exchange rate of the ringgit to appreciate, thereby making Malaysian goods and services even more uncompetitive in the international market, in addition to many other negative repercussions on the domestic economy.

Nevertheless, the impact of the interest-rate declines on the exchange rate was circumvented by the government. On September 1, 1998, Malaysia introduced selective capital control measures. The imposition of the capital controls was designed to break the link between domestic interest rates and the exchange rate so that monetary policy could be set without having the external disciplining forces of the exchange rate to reckon with. Also this turnaround in policy was motivated by the combination of a second quarter growth rate which had sunk to −6.8 per cent, volatile and unregulated capital flows that were continuing to nullify attempts by the government to revive the economy.

Essentially, the controls took the form of three main measures—international non-convertibility of the ringgit, pegging of the ringgit to the U.S. dollar (at RM

[6] The NERP had six objectives, forty lines of action, and over 580 detailed recommendations. The six objectives included stabilization of the ringgit; restoration of market confidence; maintenance of financial market stability; strengthening of economic fundamentals; continuation of the equity and socioeconomic agenda; and revitalization of affected sectors.

3.80 to the U.S. dollar), and the requirement that short-term capital stay on-shore for at least twelve months. These measures have virtually eliminated the offshore market for the ringgit, discouraged the inflow of speculative short-term capital and brought home offshore ringgit which had been removed from the country in 1997 and early 1998 in search of higher interest abroad. In addition to bringing about the independence of monetary policy vis-à-vis the exchange rate, the controls were also designed to insulate the domestic economy from the vulnerabilities of short-term capital or hedge funds. While not a solution to the crisis in itself, capital controls did provide the government with a breathing space for undertaking measures to restructure the economy, reform the banking system, and resuscitate the ailing domestic economy.

Critics and advocates of the controls alike were concerned that September 1, 1999 (exactly one year from the date on which capital controls were imposed), there would be a large exodus of funds from the country. In response to these fears, the government revised its policy on requiring that receipts stemming from capital account transactions be held in Malaysia for one year before being eligible for repatriation. Instead, the government introduced an exit tax with variable rates depending on the length of stay of the receipts. Under the exit levy system, foreign funds other than FDI were divided into two categories, those in Malaysia prior to February 15, and those that came in on or after this date. A special external account was created under the exit levy system for investors who intended to bring portfolio investment into Malaysia on or before February 15. Under the new ruling, original capital brought in before February 15, 1999 will be allowed to be repatriated within seven months subject to a graduated levy on which the duration of investment is based (see Table I).

TABLE I

EXIT TAX RATES

Form of Funds	Time Frame	Rate
A. Foreign funds in Malaysia prior to February 15, 1999		
Capital excl. FDI	Repatriated within 7 months	30%
	Repatriated between 7–9 months	20%
	Repatriated between 9–12 months	10%
	Repatriated after 12 months	No levy
B. Foreign funds in Malaysia on or after February 15, 1999		
Profits excl. principal amount	Realized and repatriated within 12 months	30%
	Realized and repatriated after 12 months	10%
	Realized after 12 months, and repatriated after 12 months	10%
	Realized during the 12 months, but repatriated after 12 months	10%
Investment in properties		No levy

IV. IMPACT OF THE CRISIS AND POLICY RESPONSES

The differences in the nature of the policy responses toward the crisis have naturally resulted in different impacts on the economy. Much has already been written about the impact on the economy in the early days of the crisis (see Ariff and Abubakar 1999; Ariff et al. 1998). As this paper is primarily concerned with the post-crisis scenario, the impacts of the crisis and subsequent policy responses by the government on the economy are explored beginning from the shift toward more expansionary policies and currency and capital controls.[7]

A. *Impact on the KLSE*

The controversial move to implement currency and capital controls seems to have been vindicated by subsequent positive developments. By imposing the controls, the economy was helped in the short-term by forcing the return of some RM 12 billion worth of deposits parked abroad, and conversely by preventing foreign portfolio funds, estimated at 23 per cent of KLSE capitalization, from being repatriated. The controls further enabled the easing of interest rates without fear of negatively affecting the ringgit, and this subsequently enabled the reflation of the economy to take place.

The KLSE indices more than doubled from 300 prior to the imposition of the controls, to more than 600 in February 1999, even breaking through the 800-point psychological barrier in July 1999. In that sense, it could be argued that the controls have helped to bring about a measure of stability in the Malaysian economy, although it is not the only factor. So far, the Malaysian capital controls have had a positive psychological impact, at least on domestic business and consumer confidence. Even the large-scale currency black market that was foreseen, did not eventually materialize, due to a strong balance of payments and rising foreign exchange reserves. Care must nevertheless be exercised when using the stock market indices as a measure of the health of the real economy. The stock market is driven primarily by investor sentiments, and as events in the early days of the crisis have demonstrated, investor sentiments do not necessarily run parallel with the real economy, in a sense that stock market rallies can occur even when the economic situation is not favorable, and vice versa. Notwithstanding this, the level of robustness in the stock market can usually provide some general indication of the future outlook of the economy as it rests on investor and business confidence in the economy.

[7] Expansionary policies started to be pursued in earnest after the imposition of currency and capital controls on September 1, 1998.

B. *Impact on Business Confidence Levels*

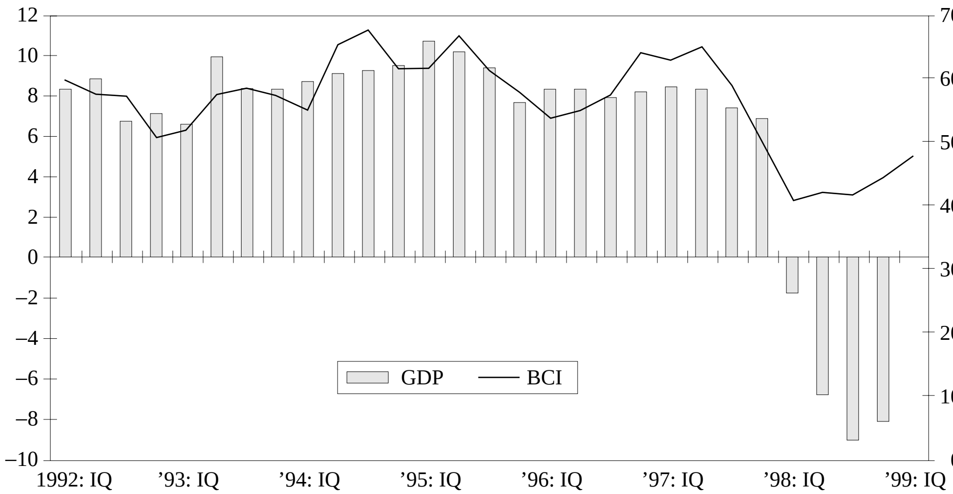
To gauge the perceptions at the ground level, Malaysian Institute of Economic Research (MIER) conducted a survey among companies in the manufacturing sector to determine the impact of the currency control measures on their business operations and future investment plans two months after the controls were imposed. Among the more interesting findings was the fact that most of the companies surveyed found that the controls and the currency peg had brought about much needed stability and would enable companies to plan ahead. However, slightly more than half of the companies surveyed expected an increase in their transaction costs and bureaucratic red tape. Nevertheless, the majority (85 per cent) indicated that they planned to maintain their level of investment in the next one-three years, although a number of respondents expected some slowdown in foreign investments (MIER 1999b). To a certain extent, the findings reflected a cautiously optimistic sentiment among the survey respondents. In the case of the fixed exchange rate, the survey showed that it had certainly been effective in reducing the instability caused by the fluctuation of the exchange rate. It had also been helpful in a sense that businesses with international links no longer had to factor an exorbitant "exchange rate risk premium" into the calculations of their business plans, and thus were able to keep their prices and costs relatively low (MIER 1999b).

C. *Impact on Foreign Direct Investment*

While currency and capital controls have brought about stability and restored confidence at home in the immediate term, their medium- and long-term effects are likely to be somewhat unfavorable. Although the measures were not specifically targeted toward foreign direct investment (FDI), it has become increasingly apparent that foreign investors are uneasy about Malaysia's capital control measures (MIER 1999b), mainly because they reflect negatively on policy coherence and predictability, at least in the perception of foreign investors. The removal of Malaysian stocks from the Morgan Stanley Capital International (MSCI) Index and the International Finance Corp. (IFC) Indexes, as well as the downgrading of Malaysia's sovereign ratings represented an additional blow to international investors' confidence and recognition of Malaysia as a good place to invest. The recent move by the IFC to reinstate Malaysia can be seen in a positive light, as it may signal a similar development within the international financial community.

There was a 14 per cent increase in the value of FDI approved in 1998 compared to the previous year. For the first quarter of 1999, total FDI approvals amounted to RM 1.3 billion, still significantly below the average quarterly amount of FDI approvals in 1998. Nevertheless FDI approvals do not necessarily reflect the actual situation because not all approvals necessarily translate into implementation. In addition, the current year's net FDI inflow may include the implementation of the

Fig. 1. Business Conditions Index and GDP Growth Rates



previous year’s approvals and exclude some of the current year’s approvals. As such, increases in approvals need not reflect increases in net inflows for the year in question. A better indicator in this respect is represented by new FDI applications, which for the manufacturing sector, for the whole of 1998, totaled RM 12.7 billion (a slight decline from RM 14.4 billion in 1997). This figure marks a 12 per cent contraction in potential foreign capital compared with 1997. While the decline could be ascribed to a general sense of weariness by international investors toward economies in the region, it could also reflect a decline in investor confidence in the Malaysian economy, though this may be changing for the better.

D. *Impact on Industrial and Manufacturing Sector*

Based on the first quarter 1999 results of the business conditions index (BCI) which registered a 3.5 point increase to reach 48.5 points, there seems to be a significant turnaround in domestic demand and business confidence (see Figure 1). Preliminary results of the second quarter BCI survey show a very sharp upward trend and are indicative of an upturn in economic activities. The performance of the manufacturing sector has been particularly encouraging with higher sales recorded due to improved domestic demand. In addition, the index of industrial production (IIP) has recently showed some positive growth. Since February 1998, the IIP had been on the decline with industrial output contracting by –3.4 per cent and manufacturing output shrinking by –4.3 per cent in the first quarter of 1999. Given strong evidence of increased demand, the shrinking IIP suggested that manufacturers were instead opting to run down their inventories instead of producing more. However, industrial production for the month of April 1999 has shown a 2.6 per cent growth year-on-year, while manufacturing output grew even more strongly by 4.5 per cent compared to the previous year. In all probability, industrial production in general and manufacturing in particular will record a significant increase in the second and subsequent quarters.

E. *Impact on Trade*

In the early days of the crisis, trade was dampened as export demand by economies across the region fell. Recently though, export growth in U.S. dollar terms has shown some signs of recovery, and in fact, since the last quarter of 1998, has become positive. The improvement in external demand is largely boosted by the weak ringgit. In the short-term, this is acceptable, although it remains to be determined whether this strategy is sustainable in the long run, especially in the event of the currency peg removal or a revision of the current RM 3.80 exchange rate to the U.S. dollar. Imports, in U.S. dollar terms, increased for the first time, after many months of continuous fall, in December 1998.[8] In particular, imports of intermediate goods have increased. Although these are implications for the trade balance, this development is favorable light as it indicates rising external and domestic demand.

F. *Impact on Monetary Policy*

Following the adoption of an easier monetary policy, as mentioned earlier, the statutory reserve ratio (SRR) requirement was reduced to 4 per cent in September 1998. Interest rates also declined precipitously with the interbank (three-month) rates falling from approximately 11 per cent in September 1998 to 6.4 per cent in February 1999. The base lending rate (BLR) for commercial banks declined from 11.96 per cent in March 1998 to 8.05 per cent in March 1999. In order to stimulate the economy and to reach a growth rate of at least 1.0 per cent, Bank Negara had set a loans growth target of 8.0 per cent to be achieved by the end of 1998. Unfortunately, the target was not achieved and overall, loans growth still remains sluggish. To a certain extent, this is due to an overly cautious stance by banks and a depressed demand for credit. While loans growth is needed to stimulate the economy, the compulsion on banks to achieve a set target may inadvertently result in loans being extended to companies of doubtful credit standing or for nonviable projects. In the long run, this may have adverse implications for the asset quality of banks.

G. *Impact on Financial Sector*

Malaysia has made remarkable progress in terms of financial-sector restructur-

[8] Imports and exports fell in the first two months of 1999 before increasing again in March, April, and May.

ing. Nevertheless there are still some remaining sources of concern, including the banking system's risk management, and the consolidation of the banking and financial sector through mergers. Serious attention must be given to the process of corporate-debt restructuring, under the jurisdiction of the Corporate Debt Restructuring Committee (CDRC). It must be emphasized here that out of sixty applications for debt restructuring, the CDRC has approved only six. As restructuring of corporate debt is an important component of the entire framework of financial sector reform, it is essential that more progress be made in this respect. Asset management is also a pivotal arm of the financial-sector reform framework. All care must be taken to ensure that after acquiring the assets, they are managed well. Ironically, we may never know until it is too late just how well the assets are being managed.

It is encouraging to note that in terms of NPL resolution, Korea and Malaysia have made the most progress based on a region-wide survey by the international rating agency Fitch IBCA (Chin 1999). However, it must be remembered that reading NPL figures can be very misleading, especially in the Malaysian case. After September 1998, the government reverted back to the precrisis definition of NPLs as loans not serviced for six months, after having earlier changed the definition of NPLs as loans not serviced for three months, in an attempt to downsize the problem on paper. For example, at the end of December 1998, the ratio of NPLs to total loans stood at 9 per cent based on the six-month definition, or 14.9 per cent based on the three-month definition. Indeed, although Malaysian banks have been on a stronger footing compared to those in other regional economies, even on the eve of the crisis, Bank Negara Malaysia had made a conscious effort to upgrade its supervision.

V. RECOVERY PROSPECTS

Developments within the domestic economy such as embarking on expansionary fiscal policies, easing monetary policy, implementing capital controls, and fixing the exchange rate may lead to the improvement of growth prospects[9] for the Malaysian economy. Besides GDP figures which show an upward trend (see Figure 1), the number of car sales (which is highly sensitive to economic fluctuations and thus is a fairly reliable indicator of economic conditions) are also rising.[10] Thus, one can infer that the Malaysian economy is on the mend.

Indeed, after experiencing a sharp contraction of 6.7 per cent in real GDP in 1998, MIER expects that the Malaysian economy will register a modest growth of 1.3 per cent in 1999 (MIER 1999a). This projection is likely to be revised upward in the light of recent developments. However, the growth will depend to a large

9 All the forecasts were based on MIER projections as of mid-April 1999.

10 The number of car sales rose from 12.883 units in September 1998 to 20,694 units in March 1999.

Fig. 2. Index of Consumer Sentiments

extent on the domestic sector rather than on the export markets. In the domestic economy, public sector, rather than private sector expenditure, will be the primary engine of growth for the economy in 1999. In general, the fiscal boost by the government in 1998 is beginning to show signs of bearing fruit. Both public investment and consumption are expected to rise, in contrast to the decline experienced in both categories in the previous year.

Private sector spending, meanwhile, is anticipated to show a modest growth in 1999 following a decline of 12.4 per cent in 1998. In terms of consumer spending, the improvement of job market conditions, higher business and consumer confidence, as well as a rally in the stock market are expected to further boost the economy in the future. The first quarter 1999 MIER consumer sentiments index (CSI), shows a healthy uptrend (see Figure 2) and is indicative of the improvement of the domestic demand in the future. Private-sector investment growth is projected to recover marginally by 1.2 per cent in 1999 after having plunged dramatically by 57.8 per cent in the previous year. On the whole, the outlook is positive especially given the lower cost of borrowing, and improvement in the business environment which in turn will translate into higher investments.

Exports of goods and non-factor services are also expected to recover modestly following a decline of 0.7 per cent in 1998. Due to the large import content of Malaysian exports, imports are expected to rise in tandem with the recovery in exports and investments. However, imports are projected to grow at a faster pace in

1999. On the whole, the merchandise balance is expected to record a slightly smaller surplus of RM 56.9 billion in 1999 compared to RM 69.3 billion in 1998. At the same time, the services balance is forecast to be in deficit to the tune of RM 20.6 billion which is less than the 1998 deficit of RM 23.4 billion. The current account balance will thus record a surplus of RM 30 billion in 1999, a decline of RM 6.1 billion compared to the previous year. In terms of nominal gross national product, the current account surplus will amount to slightly more than 10 per cent.

Inflationary pressures are anticipated to remain relatively low in 1999, continuing the downward trend first detected in mid-1998. This has been largely due to the fixing of the ringgit exchange rate to the U.S. dollar, which has somewhat reduced price-markups as a result of insulation from exchange rate fluctuations. Fixing the exchange rate has virtually halted imported inflation, a major problem throughout the previous year. In the first two months of 1999, inflation stood at 4.5 per cent. Producer prices also declined during the first two months of 1999 with the producer price index (PPI) contracting by 4 per cent for the period compared to an increase of 15.3 per cent in the corresponding period the year before. As a result, the inflation rate is projected to be 3.7 per cent in 1999 following a rise of 5.3 per cent in the previous year.

The unemployment rate in 1998 was 3.9 per cent. Although current employment opportunities still seem weak, a slight improvement is expected in the future. With more consumers expecting better job opportunities in the coming months, it is anticipated that the unemployment rate will at least stabilize, if not decline slightly, mainly due to the brighter prospects in the manufacturing, construction, and financial sectors which were all severely hit by the crisis. Thus, there are unmistakable signs of recovery for the Malaysian economy.

It is pertinent to reiterate that similar recovery signs are being perceived in other regional crisis-hit countries as well. This development is favorable in that regional recovery may lead to increased opportunities for Malaysia to export its goods. As Malaysia conducts approximately 56 per cent of its trade with other East Asian countries, their recovery is the key to Malaysia's own recovery. However, the fact that recovery processes were dissimilar in the different economies suggests that there is no standardized policy prescription for economies experiencing financial and economic crises. Conventional measures seem to have worked quite well in Indonesia, Korea, and Thailand, just as unorthodox measures have in Malaysia. In that sense, the recovery may not be significantly related to actual policy prescriptions, but more related to invisible market forces adjusting themselves rationally and reorienting themselves after the irrational overshooting that characterized the initial stages of the crisis. Regional stock markets are widely expected to stabilize around realistic levels after some initial overshooting in the opposite direction.

In addition, the recovery in Malaysia may appear to be slow in comparison with that in some of the other economies in the region, especially Korea which is aiming at more than 4 per cent growth in 1999, though some indicators show that the growth rate may very well reach 6 per cent. Arguably, Malaysia's slower recovery may stem from two or three factors. Firstly, the delayed recovery may be due to the staggered nature by which the crisis unfolded in the region, affecting one country after another in a domino fashion. The pace of recovery may simply be a case of countries succumbing sooner recovering faster. Secondly, the comparatively slow pace of recovery could also be due to the delayed response by the Malaysian government during the initial stages of the crisis. Malaysia wasted valuable time during the onset of the crisis by prolonging the denial phase and not taking comprehensive measures to address the crisis until thirteen months after the crisis when the National Economic Recovery Plan was unveiled. Thirdly, even after the government embarked on a fiscal stimulus plan, various vacillations in the planning and implementation of projects may have also contributed to the comparatively slow pace of recovery. The planned RM 9.6 billion fiscal deficit for 1998 turned out to be only half of the original estimate, while public expenditure in the first quarter of 1999 also fell short of the intended target. Nevertheless, the government is taking the necessary steps to ensure that half of the 1999 allocation is actually expended in the first half of the year, though it must be noted here that the quality of public investments must not be traded off for quantity.

VI. ISSUES AND FUTURE CHALLENGES

However tempting, it cannot be generally concluded that the currency and capital controls were specifically responsible for the turnaround in the economy—i.e., declining interest-rate levels, stock market rally, balance-of-payments current account surplus, and increased foreign exchange reserves—as similar developments have been witnessed in other economies like Thailand, Korea, and Indonesia, countries that did not implement similar controls. Whatever the case, it seems that a perceptible turnaround in the economy has taken place recently. To ensure that Malaysia's recovery is sustainable and balanced however, it is inappropriate merely to treat the symptoms and not the actual disease. In other words, while there had been adequate policy responses to counter the symptoms of the current economic crisis prior to July 1997, such as overvalued exchange rates (treated by fixing the ringgit exchange rate to 3.80 to the U.S. dollar), credit crunch that led to rising inflation rates (reducing statutory reserves and interest rates), inflationary pressures (price controls on a variety of essential consumer items), and retrenchment and unemployment (repatriating foreign workers), equal attention must also be paid to solving the root causes or weaknesses that led to the crisis. Toward this end, nothing short of major economic reforms will suffice.

In the case of Malaysia, it has been demonstrated that attempts to promote reforms are politically hazardous especially when the potential losers are politically influential. Observations show that politics often overrides economics, unless there is strong external pressure from such institutions as the IMF. Given that Malaysia lacks this form of external pressure, any push for economic reforms will necessarily have to come from within, since Malaysia must remain internationally competitive. Some of the more salient challenges for Malaysia to overcome in the future are listed below.

A. *Continuing to Pursue Liberalization*

The recent move by the government to institute exchange and capital controls has elicited a variety of responses from many quarters. When capital controls were first imposed, there was a fear that Malaysia was going to become more protectionist and worse still, shut itself off from world markets. However, anyone with sound knowledge of the Malaysian economy should know that this is certainly not the case. In reality, as a small open economy that depends critically on foreign markets, foreign capital, foreign technology, and even foreign labor, Malaysia cannot afford not to be liberal. The fact remains that Malaysia has become increasingly more liberal over time, the recent imposition of temporary exchange and capital controls notwithstanding. For one thing, the controls were not aimed at foreign direct investments. In addition, in the face of the current crisis, the Malaysian authorities have further liberalized equity rules, permitting 100 per cent foreign equity for new investments in the manufacturing sector until the year 2000. Import duty exemptions on raw materials and intermediate inputs which were previously confined to export manufacturing only, have now been extended to domestic-oriented manufacturing as well.

Regulations on foreign equity have also been relaxed for some industries in the services sector such as telecommunications, energy, and insurance, although there is still some reluctance on the part of policymakers to open up the banking sector citing the unreadiness of the banking sector to face international competition. However, the banking sector's current inefficiency stems from the fact that it has been sheltered for too long from international competition. Exposure to foreign competition will instead force the local banks to innovate and cut costs. Foreign ownership of domestic banking institutions is still limited to 30 per cent, with foreigners having equity stakes in twelve Malaysian-owned banks, notwithstanding the thirteen (of a total) thirty-five commercial banks in the country which are fully foreign-owned. Foreigners currently account for about 24 per cent of the total banking system assets. The challenge for the future, as the current crisis has highlighted, is to continue to liberalize the banking industry as it would benefit from new capital injections. However, the establishment of "special purpose vehicles" like Danaharta and Danamodal has circumvented the above need to a certain extent. The whole issue of liberalization is rather complex in Malaysia, and therefore should be approached with caution, especially the size and speed of liberalization which some have argued may be the cause of the crisis. On the whole, further efforts toward liberalization are desirable in the Malaysian context, although a gradual, rather than "big bang," approach is recommended.

B. *Foreign Direct Investment*

While the various emergency measures implemented by the government in September 1998, as well as the domestic resources that it can avail itself of, can help to halt further economic erosion and to stabilize the situation, they cannot by themselves lift the Malaysian economy back to its original growth trajectory. What is needed in this respect is the resumption of large inflows of foreign capital into the economy. Malaysia has had to resort to external borrowing to finance its recovery, but even this has been a costly maneuver given the downgrading of the country's sovereign rating. Fresh capital inflow remains the only viable alternative. Currently, the Malaysian economy is quite anemic following the massive outflow of capital during the period between the onset of the crisis in July 1997 and the imposition of capital controls in September 1998. A substantial capital transfusion is needed to revive the flagging economy, and to achieve this objective, effective policies to attract both Malaysian capital parked abroad and also new foreign capital are sorely needed.

After the onset of the crisis, investment figures were less than encouraging. In 1998, FDI approvals (RM 13.1 billion) exceeded FDI applications (RM 12.3 billion), which is not surprising since project approvals during a period may include project applications received in the preceding period. Figures from the Malaysian Industrial Development Authority (MIDA) show a 15.9 per cent increase in the FDI project approvals in 1998, but a decline of 7.4 per cent in new FDI applications. Most approvals have yet to be translated into actual investments. In January 1998, the number of total new FDI applications was even smaller than the monthly average for 1998. Clearly, the foreign exchange controls are not entirely conducive to capital injection from abroad. While it is clearly stated that the controls will not affect FDI, the controls seem to exert an indirect negative effect on FDI, especially in terms of the general erosion of investor confidence in Malaysia. The replacement of the one-year moratorium on portfolio investment profits with a graduated exit tax scheme is a step in the right direction, though further easing of controls is deemed to be necessary.

Besides easing capital controls, the Malaysian government must continue to attract more long-term investors by further liberalizing the services sector, particularly the banking and insurance sector. The focus of the government until now had been the liberalization of the manufacturing sector. Given the current level of excess capacity in this sector, however, it is unlikely that foreign investors would want to invest further. This alone should provide the impetus for the government to seriously consider the liberalization of other sectors, especially the services sector, as well.

C. *Building Good Governance and an Ethical Regulatory Framework*

As there is increasing evidence that governance problems exert an adverse effect on economic performance, a broader consensus has emerged on the central importance of transparency and good governance for achieving economic success. In the case of Malaysia, public-sector macroeconomic governance has been comparatively good by regional and global standards. Fiscal discipline and monetary prudence have been the hallmarks of the Malaysian government since the mid-1980s onwards. Bad public sector governance is not the main cause of the current crisis, though it must be mentioned that government excesses in the form of ambitious growth targets, heavy industrialization programs and costly infrastructure projects had become increasingly prevalent, especially during the period leading up to the crisis.

It has been argued that one of the main causes of the current crisis is poor private-sector governance. Examples include the use of short-term borrowings to finance long-term investment projects, the preference for debt-financing as opposed to equity-financing, and the basing of lending, borrowing, and investment decisions on noncommercial considerations. Realizing that technical, top-down macroeconomic management is now beginning to lose its importance, the role of government must instead be redirected toward being a facilitator, orchestrator, and regulator of private economic actors. In a recent survey on corporate governance, it is interesting to note that more than half of the total respondents from both public-listed companies as well as institutional groups indicated that improvements needed to be made on the corporate governance regime in Malaysia (Teoh 1999). There is some evidence to show that the government recognizes this fact and is moving toward this goal. In March 1998, the government set up the Finance Committee on Corporate Governance to look into the matter. Recently, the committee has come up with some seventy recommendations aimed at improving the market practices of listed companies by setting good governance principles. Mere principles however, will not translate automatically into practice without regulation and enforcement. As such, one would expect that good governance and best practice principles would take a fair amount of time to seep into the system. In the realm of finance and banking, Danaharta and Danamodal are in the best position to insist on best banking practices as a condition for debt-restructuring and recapitalization.

The Securities Commission and KLSE also have a role to play by encouraging greater corporate disclosure, codes of conducts, and business ethics, as well as the implementation of other internal controls by all the public-listed firms. Currently, companies seeking to be listed on the KLSE Second Board are required to have a minimum paid-up capital of RM 40 million, up from the RM 10 million required previously. Meanwhile, the KLSE has introduced new measures to improve corporate governance and transparency by making it compulsory for listed companies to release their financial results on a quarterly basis and by limiting the number of directorships that an individual may hold in listed companies to ten.

Moral hazard, in this context a phenomenon associated with reckless borrowings and lendings during good times, based on the assumption that governments will come to the rescue during bad times, is also strongly related to the issue of governance because its occurrence is often the result of bad governance practices. It is worrying to note that although efforts are being made by the government to improve the corporate governance climate in the country, there has also been some backsliding, for example, the use of public funds such as the Employees Provident Fund for propping up the stock market and rescuing privatized public enterprises, an occurrence that was especially apparent during the present economic downturn.

There is also a need to safeguard the interests of minority shareholders who are often sidelined in major corporate restructuring exercises. From a moral and ethical standpoint, when things go wrong, it is those who are responsible for the fiasco in the first place who should bear the burden of paying for their mistakes, and not the public at large. Failure to do so will result in a skewed condition whereby profits are privatized, but losses are virtually socialized. By making privatization projects, development projects and public procurement exercises fully transparent, and enabling greater and easier access to this information, the problem of moral hazard can be alleviated. In addition, a competition policy can help to lay the ground for the creation of a level playing field for all firms.

D. *Restructuring and Upgrading the Industrial and Technological Base*

In order to build an even stronger foundation and achieve a more sustainable economic growth, as well as to ensure Malaysia's international competitiveness in the future, fundamental changes have to be made upon the industrial base of the economy. Economists argue that the government's persistence in promoting capital-intensive industries could divert much-needed funds into sectors that few expect to become regionally competitive (Lopez 1999). In retrospect, it can be said that Malaysia's foray into heavy industries in the 1980s was a mistake given the near absence of the country's short-term comparative advantage to tap into the world market. In addition, its small domestic economy precludes it from taking advantage of the economies of scale. The automobile and steel industries have long been the recipients of protection on the grounds of infant industry status and do not seem to show any signs of progressing beyond this stage. Perwaja Steel for example, the country's iron and steel manufacturer is saddled with a huge debt and its products remain internationally uncompetitive. Restructuring therefore, becomes imperative. It is heartening to note that in the case of Malaysia's automotive sector, a merger of motor vehicles vendors that feed the two national car manufacturers, Proton and Perodua, is being planned to create a multi-tiered vendor system with a global orientation.

The underlying problem in Malaysia's industrial sector lies in the fact that it is losing its comparative advantage in labor-intensive goods and services in the face of growing competition from countries such as China and India that enjoy considerable cost advantage in unskilled and semi-skilled labor. At the same time, the Malaysian economy has yet to fully realize its comparative advantage in producing skill-intensive, high-technology goods and services. Given Malaysia's small domestic labor force, one solution, though clearly untenable in the long-term, is to maintain the economy's dependence on migrant labor. Clearly, Malaysia's development path in the future is in higher value-added industries and due emphasis of this fact has been given in the Seventh Malaysia Plan. Relatedly, any attempt to upgrade Malaysia's industrial sector will depend on the soundness of its technology policy. To be truly effective, attention must be paid to crafting policies on education and human resource development, improving the technological infrastructure, expanding the Asia-Pacific market (Soesastro 1998) and moving away from dependencies on migrant labor (Abubakar 1999).

VII. CONCLUSION

There are many lessons that can be learned from Malaysia's experience with the crisis. It is clear that, besides the impact of the crisis on the economy, the various government policy responses also have an equally significant effect on the economy. It is very important that this is understood and taken into account when formulating policies in the future. Like the economic crisis in the mid-1980s through which the government learned the importance of maintaining good macroeconomic management, this current episode holds many lessons, albeit of a different nature, for the government. The crisis has shown that rapid and high economic growth is largely not sustainable in the long run, particularly if it is not accompanied by an equal buildup of governance institutions at the firm and national levels. Above all, the crisis has shown that a measure of coherence and consistency in policy-making must always be maintained. Otherwise, investors will always attach a discount to Malaysia because of policy concerns and uncertainties.

With the economy turning the corner and key indicators showing signs of recovery, the time is perhaps ripe to look beyond the crisis at the new drivers of economic growth. Total factor productivity, rather than input-driven growth will be a key source of growth in the future. Obviously, growth in terms of GDP will be lower, but this will be offset by higher quality, more durable growth. In support, Saker (1999) maintains that " . . . the changes that have taken place already amount to a substantial improvement to the underlying economic structures. Reforms have taken place in a wide range of areas including those which, in pre-crisis times, were considered sacrosanct. Among these are ownership rules; liberalisation of investment rules; improvement of banking-sector prudential regulation; capital market reform; corporate governance reforms; and corporate restructuring." (p. 12) Saker argues, quite rightly, that these changes should yield several positive aspects for growth as they create supply-side efficiency gains. For example, as bond markets are opened up, financial sector activities are likely to expand, contributing positively to GDP growth. Similarly, as barriers to investment in certain sectors are eliminated as a result of the removal of restrictive legislation, local businesses will find new areas of growth. Additionally, with better regulation systems in place, systemic risk in the economy is likely to be reduced.

In retrospect, it could be argued that the economic crisis was a much needed wake-up call for Malaysia (and other countries in the region) which prior to the crisis was more concerned with achieving quantitatively, rather than qualitatively, high economic growth. Clearly, the "more is better" mentality is out of step with Malaysia's development needs at the present time. With the bitter and painful experience of the economic crisis hopefully behind it, and a serious approach toward undertaking the appropriate reforms adopted, it is not unlikely that Malaysia will emerge even stronger and more competitive in the long run.

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